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Sahara Energy Ltd.

2006 Annual Report



Gold Creek 4-26 Facility

SAHARA ENERGY LTD.

REPORT FOR THE FIRST FULL YEAR

January 01, 2006 to December 31, 2006

Highlights – 2006

- Completed financings to raise additional capital of \$ 9,654,589
- At December 31, 2006 Sahara had 19,368,083 shares outstanding.
- First full year of operations – Operated 17 wells
- Participated in 47 wells (18.3 net wells)
- Drilling Success of 80%
- Finding costs of \$13.00 per barrel
- Total Proved Reserves of 544,000 BOE
- Became a fully staffed operating company

Highlights – 2007

- Current production of 285 boepd and behind pipe potential of 165 boepd
- Total Production capability of 450 boepd
- Participated in 62 wells to date
- Sahara Gold Creek facility commenced production mid-April

REPORT TO THE SHAREHOLDERS OF SAHARA ENERGY BY THE PRESIDENT

To The Shareholders

Sahara Energy Ltd. is pleased to report operating results for the year ended December 31, 2006. Industry drilling and service costs during 2006 were higher than anticipated which proved to be challenging for Sahara. As a result of these excessively high costs Sahara scaled back its drilling operations during the 4th quarter. During the year, Sahara was involved in drilling 47 prospects (17 operated and 30 non-operated), resulting in 29 producing heavy oil wells, 2 light oil wells, 3 gas wells, 4 standing wells and 9 dry and abandoned wells. During 2006 Sahara operated 11 producing wells, including 2 wells at Grand Prairie, 7 wells at Lloydminster, 1 well in Saskatchewan and 7 dry and abandoned. Sahara successfully operated these wells in 2006 in a challenging environment of high service costs and historically high drilling costs. With this experience Sahara has transformed itself into an operating company fully capable of successfully operating in the current lower cost drilling environment. Sahara delayed its drilling program because of these high costs but now expects its drilling and service costs to be substantially lower going forward in 2007. As a result of this realignment of costs Sahara plans

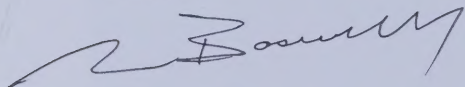
to operate 10 wells in the Hayter, and Lloydminster area of Alberta and 1 well in the Tangent area of Alberta.

Sahara's well count is currently at 62 wells, with an average working interest of 40%. Sahara has an inventory of 50 locations, (average 40% working interest) that have been identified with either 2D or 3D seismic.

At year end, Sahara was producing 210 bopd (heavy oil), 45 bopd (light), with 4 gas wells at various stages of being placed on production.

The Company is currently producing 285 BOEPD which consists of 200 bpd of heavy oil, 55 bpd light oil and 200 mcf/d gas. Sahara has behind pipe production capability of 165 BOEPD consisting of 70 bpd oil and 600 mcf/d gas for total production capability of 450 BOEPD. All of Sahara's production was found via the drill bit, Sahara did not purchase any production. In order to further exploit Sahara's drilling opportunities, Sahara will need further financings which will depend on market conditions.

Sincerely;

A handwritten signature in dark ink, appearing to read "Peter Boswell", with a stylized, flowing script.

Peter Boswell
President and CEO
June 1, 2007

INTRODUCTION

Sahara explores for opportunities that fit the following corporate criteria

BALANCED PRODUCT MIX – Heavy Oil, Deep Gas and Light Oil

BALANCED RISK PROFILE – Shallow heavy oil and gas vs. Deep gas

We can make it happen by relying on:

STRONG TECHNICAL TEAM + SOLID INDUSTRY EXPERIENCE = Lots of Deal Flow

Our areas are selected on the following profile.

- Multi zone targets
- Shallow to medium depth
- Seismically defined targets
- Accessibility

After evaluating over 75 prospects, we have chosen the following as our core areas.

These areas were chosen based on accessibility, well costs, multi zone potential and Sahara's management's extensive technical and deal experience in these areas.

Core Areas

Lloydminster, Alberta/ Buzzard, Saskatchewan

Grande Prairie, Alberta

Central Alberta

CORE AREAS

HEAVY OIL (Lloydminster/Lashburn areas)



Typical wellsite Lloydminster, Alberta

During the fourth quarter of 2006, Sahara operated two wells at Lloydminster, Alberta (75% working interest). Sahara also participated in the drilling of 5 heavy oil wells at Buzzard (30% working interest) and 1 heavy oil well at Dee Valley (30% working interest).

Sahara currently has an interest (40%) in 35 producing oilwells in the Lloydminster area of Alberta and the Lashburn/Buzzard areas of western Saskatchewan. After spring break-up, Sahara will operate and drill (50% working interest) 8 heavy oil development locations. The Company may participate in an additional 10 non-operated heavy oil development locations. The Company has identified 17 heavy oil development prospects to be drilled on Company lands.

GAS/LIGHT OIL (Grande Prairie area)



Gold Creek pipeline construction

At the Sahara operated Gold Creek 4-26 (20% interest), two zones were perfed and fracture stimulated. At December 31, the testing and completion of the well had resulted in a Halfway gas reservoir and a Nikannassin gas reservoir. Currently, the Halfway gas is producing at a rate of up to 1 mmcf/d. The Nikanassin zone which was completed, fracture stimulated and production tested, - will be placed on production at a later date.

In December, Sahara participated in a second well in the Gold Creek area of Alberta (17% interest). Subsequent to year end, this Halfway oil test well has been cased, completed and placed on production as a confidential Halfway oilwell. Sahara and partners have identified two development locations on 3D seismic for this 640 acre prospect.

During November of 2006, Sahara participated for 15% WI in the drilling of a Cadotte gas well in the Simonette area of Alberta. Initial testing suggested a virgin reservoir with limited drawdown. Subsequent to year end, this well has been tested, completed and tied in at a rate of 1 mmcf/d. The operator is increasing the well to 3 mmcf/d after pipeline issues are resolved in the near future.

In December, Sahara participated for 20% in a Paddy gas test at Sinclair, which was dry and abandoned.

During the year, Sahara operated two light oil prospects west of the Fifth Meridian. At Pembina, one Cardium oil well (75% interest) and at Tangent, one Montney oil well

(30% interest). At Tangent, the well is producing 120 bopd (net 36 bopd) of light oil, with two future development locations on this 640 acre prospect. One non-operated well was drilled at Willisden Green (17% interest) which was drilled, cased and completed. Test results indicated a limited gas reservoir in the Ellerslie Formation, which will be tied in at a later date.

GAS/LIGHT OIL (Southern Alberta)

In the Little Bow area of southern Alberta, Sahara evaluated 13 sections of land under a 3D seismic option which identified several Mississippian targets. To evaluate this play a well was re-entered at 02/16-35. The Mississippian zone was perfed, resulting in a non-commercial zone. The well is currently being evaluated for uphole shallow gas potential. At Little Bow two additional Sahara operated wells were drilled and cased for Bow Island Gas. Upon completion, both wells encountered non-commercial rates of hydrocarbons and were plugged. The uphole shallow gas potential is being evaluated at this time.

Treaty Land Entitlement (TLE Lands)

At year end, Sahara has “frozen” 8,840 acres of TLE mineral rights with the Mosquito Grizzly Bears Head Lean Man First Nation. The lands are situated in Western Saskatchewan. Sahara also has the exclusive right to explore and develop oil and gas prospects on 60,000 acres of land on the Mosquito Grizzly Bears Head Lean Man First Nation, located at North Battleford, Saskatchewan. This agreement is in effect until February, 2009.

FUTURE OPERATIONS

After break up, Sahara will operate the drilling of 8 oil heavy oil test wells. In Alberta, 2 test wells will be drilled at Hayter (50%), 2 test wells at Blackfoot (50%), 2 test wells at Lloydminster (75%) and 2 wells (50%) at Soda Lake, Saskatchewan. In the next 6 months Sahara may also participate in the drilling of 10 non-operated wells (30%) in the Buzzard/Lashburn area of western Saskatchewan, with one Ellerslie gas test well planned at Wood River, Alberta (12% interest).

SAHARA ENERGY LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year ended December 31, 2006

Management's Discussion and Analysis ("MD&A") dated April 17, 2007, is management's assessment of the historical financial position and operating results of Sahara Energy Ltd. ("Sahara" or the "Company") to review financial results for the year ended December 31, 2006. The information has been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the audited financial statements for the period ended December 31, 2006 and 2005.

Additional information relating to the Corporation, Sahara's *Statement of Reserves Data and Other Oil and Gas Information* are available on SEDAR at www.sedar.com. Sahara is listed for trading on the TSX Venture Exchange under the symbol "SAH".

Forward-looking Statements

This disclosure includes statements about expected future events and/or financial results that are forward-looking in nature and subject to substantial risks and uncertainties that may cause the actual results, performance or achievements expressed or implied by such forward-looking statements to differ. These risks include, but are not limited to: petroleum and natural gas price volatility, interest rate fluctuations, availability of services and supplies, market competition, uncertainties in the estimates of reserves, the timing of capital expenditures, production levels and the adequacy of funding for capital investments. Sahara Energy Ltd. cautions that actual performance will be affected by a number of factors, many of which are beyond its control.

Non-GAAP Financial Measures

This MD&A includes references to financial measures commonly used in the oil and gas industry. The terms "net petroleum and natural gas revenue" (petroleum and natural gas sales less royalties, production expenses and transportation costs) and "funds from (used by) operations" (net loss for the period adjusted for non-cash items in the statement of operations) are not GAAP measures and do not have standardized meanings prescribed by GAAP.

BOE Presentation

The term barrel of oil equivalent ("boe") may be misleading, particularly if used in isolation. All boe conversions in this report are derived by converting natural gas to oil in the ratio of six thousand cubic feet of natural gas to one barrel of oil. This conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Overview

As at December 31, 2006, the Company reported a cash balance of \$2,100,405 and a working capital deficiency of \$1,298,912. For the year ended December 31, 2006, the Company had net revenues of \$692,746. The Company had a net loss of \$1,474,635 for the year.

Adjusting the net loss for non-cash items of depletion, depreciation, accretion and stock based compensation the Company had a net loss of \$271,241 for the year ended December 31, 2006.

During the year, the Company incurred capital expenditures totaling \$11,652,911 with expenditures of \$4,949,157 for the three month period ended December 31, 2006. During the year the Company spent \$2,041,893 on land, \$8,535,022 on exploration and development drilling and \$1,075,996 on well equipment and facilities.

OPERATIONS AT YEAR END

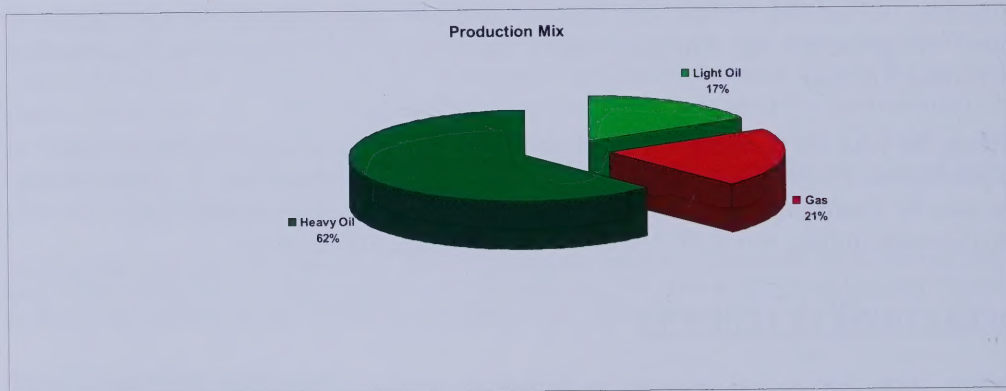
During 2006, Sahara was involved in drilling 47 prospects, resulting in 29 producing heavy oil wells, 2 light oil wells, 3 gas wells, 4 standing wells and 9 dry and abandoned wells. At year end, Sahara was producing 200 bopd (heavy oil), 45 bopd (light), with 4 gas wells at various stages of being placed on production.

The Company is currently producing 285 BOEPD which consists of 200 bpd of heavy oil, 55 bpd light oil and 200 mcfd gas. Sahara has behind pipe production capability of 165 BOEPD consisting of 70 bpd oil and 600 mcfd gas for total production capability of 450 BOEPD.

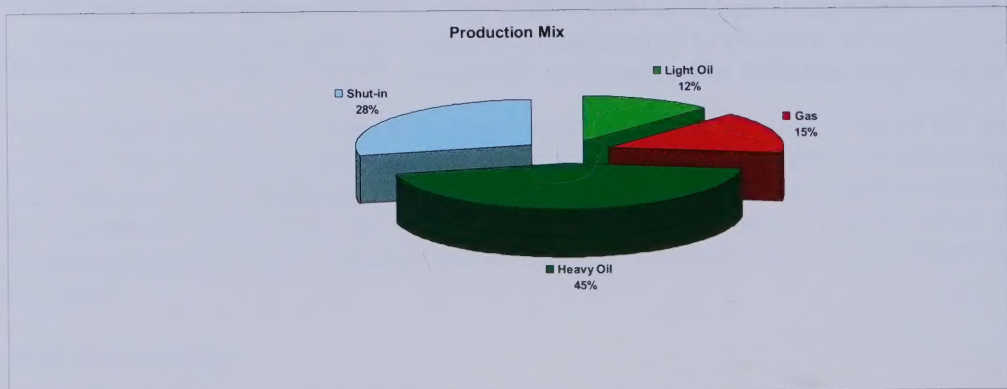
Sahara's well count is now at 62 wells with an average 38% working interest. Sahara currently has an inventory of 50 locations in inventory, (average 40% working interest) that have been identified with either 2D or 3D seismic.

Product Mix

CURRENT PRODUCTION - 285 boepd



TOTAL CAPABLE PRODUCTION - 450 boepd



Selected Annual Information

Year or period ended December 31, 2005	2006	2005 ¹
(\$ except for share information)		
Petroleum and natural gas revenue	818,571 ²	Nil ²
Total revenues, net of royalties	692,746 ²	Nil ²
Funds from (used by) operations	(271,241)	(117,599)
Net loss	(1,474,635)	(358,308)
Loss per common share – basic and diluted	(0.10)	(0.09)
Total assets	19,794,445	4,040,572
Working capital (deficiency)	(1,298,912)	2,050,099
Total debt	785,000	-
Shareholders' equity	10,462,543	3,758,580
Common shares outstanding:		
- basic	19,368,083	10,716,000

¹ The Company commenced operation on January 5, 2005.

² The Company commenced oil and gas sales in January 2006.

Selected quarterly information

	Net Income (Loss)	Loss per Share	Net Production Revenue
(\$ except for share information)			
2006 Q4	(572,084)	(0.04)	311,344
2006 Q3	(92,590)	(0.01)	215,746
2006 Q2	(514,816)	(0.04)	103,557
2006 Q1	(295,145)	(0.03)	62,099
2005 Q4	(316,202)	(0.08)	Nil
2005 Q3	(44,151)	(0.01)	Nil
2005 Q2	1195	0.00	Nil
2005 Q1	850	0.00	Nil

Production

Sahara's sales volumes during the year averaged 55 BOPD and for the fourth quarter averaged 103 BOPD, up from 85 BOPD in the third quarter. During the fourth quarter operational difficulties and tie-ins caused several production delays. Sahara's December 31, 2006 exit rate totaled 240 bopd, consisting of 200 bopd of heavy oil and 40 bbls/d of light oil. The Company is currently producing 285 BOEPD which consists of 200 bpd of heavy oil, 55 bpd light oil and 200 mcf/d gas. Sahara has behind pipe production capability of 165 BOEPD consisting of 70 bpd oil and 600 mcf/d gas for total production

capability of 450 BOEPD. Sahara's well count is now at 62 wells with an average 38% working interest.

Revenue and Royalties

Oil sales represented 100% of the total gross revenues for the first year. Crown royalties averaged 7.3% of gross sales and all other royalties averaged 8.1%. Revenues continue to increase as production behind pipe is tied in and wells drilled are completed and placed on production.

Production Expenses

Production expenses totaled \$183,238 for the three month period ended December 31, 2006 and \$420,276 for the year. The production costs are expected to lessen as the wells are no longer in start up phase.

General and Administrative Costs

General and administrative ("G & A") expenses for the three months ended December 31, 2006 were \$116,989 and totaled \$449,427 for the year. The Company also received overhead recoveries of \$170,886 for the year.

Depletion Depreciation and Accretion

Depletion costs were \$329,368 for the Quarter ended December 31, 2006 and \$540,630 for the year. Depletion costs are expected to decrease as the Company's proven reserve base increases.

Capital Expenditures

	<u>Total to December 31, 2006</u>	<u>Three months Ended December 31, 2006</u>
Land acquisitions	\$ 2,041,893	\$ 505,267
Exploration & Development drilling	\$ 8,535,022	\$3,844,273
Well equipment and facilities	<u>\$ 1,075,996</u>	<u>\$ 599,617</u>
Total	<u>\$11,652,911</u>	<u>\$4,949,157</u>

Cash Flow from Operations

	Year Ended December 31, 2006 \$818,571	Three Months December 31, 2006 \$340,908
Gross revenues		
Royalties	\$125,825	\$ 33,332
Operating Expenses	<u>\$420,276</u>	<u>\$ 183,238</u>
Net Cash Flow from Operations	\$ 272,470	\$124,338

Future Taxes

Balance at December 31, 2005	\$ 135,000
Flow through share renouncement (\$3,038,000)	<u>\$1,024.948</u>
Balance at December 31, 2006	<u>\$1,159,948</u>

Reserves

The Company's reserves were internally evaluated at December 31, 2006. In November DeGolyer & McNaughton were retained to provide a Reserve Report which is tabled below.

- Total Proved reserves of 544 M boe
- Total Proved plus probable reserves of 1,188 M boe
- Total proved, probable and possible reserves of 1,427 Moe

SUMMARY OF RESERVES AS OF DECEMBER 31ST, 2006

Reserve Category	Light Oil (Mbbbls)	Heavy Oil (Mbbbls)	Natural Gas (mmscf)	NGL (Mbbbls)
<i>Developed Producing</i>	28	207	-	-
<i>Developed Non-Producing</i>	-	12	610	3
<i>Undeveloped</i>	-	188	26	-
TOTAL PROVED	28	407	636	3
<i>Probable</i>	13	597	197	1
TOTAL PROVED + PROBABLE	41	1004	833	4
<i>Possible</i>	-	239	-	-
TOTAL PROVED+PROBABLE+POSSIBLE	41	1243	833	4

Note:

The aforementioned reserve report does not include the recently drilled and producing halfway oil well at Gold Creek.

Liquidity and Capital Resources

The Company had a cash balance of \$2,100,405 and working capital deficiency of \$1,298,912 as of December 31, 2006. Included in the working capital deficiency are \$785,000 convertible debentures that are convertible at \$0.57. Management is of the

opinion that the debentures will be converted if they stay in the money leaving a deficiency of \$503,912. The Company is in the process of securing a credit line facility that will be sufficient to meet all commitments to which it is currently committed.

The Company has issued the following flow-through shares through private placements:

Date	Number of shares	Price per share	Value received	Flow-through Classification	Renounced 2006
May 15, 2006	1,500,000	\$1.3333	\$1,999,950	CDE	\$1,999,950
Nov 01, 2006	1,000,000	\$1.33	\$1,300,000	CEE	\$1,330,000
Nov 01, 2006	1,200,000	\$1.20	\$1,200,000	CDE	\$ 360,000
Dec 29, 2006	281,964	\$1.70	\$ 281,964	CEE	\$ 281,964
Dec 29, 2006	563,928	\$1.60	\$ 563,928	CDE	\$ 270,685
	4,545,892		\$ 5,345,842		\$ 4,242,599

The Company is committed to renounce the remaining CDE expenditures as follows:

30% in 2007

30% in 2008

10% in 2009

On January 26, 2006 the Company issued 1,035 10% convertible Debentures at a price of \$1,000 per Debenture for aggregate gross proceeds of \$1,035,000. The Debentures mature on December 31, 2007 and are convertible, in whole or in part, at any time prior to maturity at the option of the holder. The Debentures are also automatically convertible at the option of the holder at any time and in the event that the Company fails to pay interest or fails to repay the principal amount and accrued interest on the maturity date. When converted, the Debentures shall be convertible into units comprised of common shares and common share purchase warrants on the basis of \$0.57 per common share together with one warrant for each common share issued. Each warrant shall be convertible into one common share of the Company at a price of \$0.57 until December 31, 2007. The holder may also convert the Debentures into cash at any time after December 31, 2006 on the basis of repayment of the principal amount together with accrued and unpaid interest to the date of conversion.

During the period, \$250,000 in debentures were exercised and converted into 438,589 Common shares by the holders of the debentures.

Commitments

The Company entered into a lease agreement for a period of five years that calls for annual basic rent payments of \$199,000 per year of which approximately half is recovered from a related Company.

Related party transactions

The Company had the following related party transactions during the year measured at the exchange rate, which is the amount established and agreed to by the related parties and which are similar to those negotiable with third parties:

A related Company by virtue of common directors owes \$700,760 (2005 - \$Nil) which is included in accounts receivable for costs associated with joint venture operations during the year. The related Company also reimbursed \$85,536 for general and administrative costs incurred during the year.

During the year ended December 31, 2006, the Company was charged \$660,873(2005 - \$Nil) by a Company which was controlled by an officer and director of Sahara for engineering supervision of drilling, completion and field services. For the year ended December 31, 2006, \$139,720 (2005 – \$Nil) of the above amount is in accounts payable and accrued liabilities. This director resigned from the board of directors December 19, 2006.

A Company controlled by a director of the Company owes \$99,034 (2005 - \$(3,308)) with respect to joint venture operations on non-operated wells.

Subsequent events

The Company granted 450,000 stock options at an exercise price of \$1.30 for a term of five years with vesting provisions.

The Company obtained a revolving operating loan at an interest rate of prime plus 1%. The loan is due on demand and is secured by a general security agreement.

Critical Accounting Estimates

Management is required to make judgments, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company.

Full Cost

The Company follows the full-cost method of accounting for oil and natural gas properties, whereby all costs associated with the exploration for, and development of, petroleum and natural gas reserves, whether productive or unproductive, are capitalized in cost centers. Costs capitalized include land acquisitions costs, geological and geophysical expenditures, rentals on undeveloped properties and drilling and overhead expenses related to exploration and development activities. Proceeds from disposition of property are credited to the net book value of the property and equipment. Gains and losses are not recognized upon disposition of oil and gas properties, unless the disposition would significantly alter the rate of depletion.

Costs capitalized are depleted and amortized using the unit-of-production method based on gross proved oil and gas reserves as determined by independent engineers. For purposes of the depletion calculation, proved oil and gas reserves are converted to a common unit of measure on the basis of the relative energy content of 6,000 cubic feet of natural gas per barrel of oil.

In applying the full cost method, the Company calculates a ceiling test for each cost centre whereby the carrying value of property and equipment is compared at each reporting period to the sum of the undiscounted cash flows expected to result from the future production of proved reserves and the sale of unproved properties. Cash flows are estimated using third party quoted forward prices, adjusted for transportation and quality, less estimated costs directly associated with the development, production and sale of reserves. Should the ceiling test result in an excess carrying value, the Company would then measure the amount of impairment for the cost centre by comparing the carrying amounts of property and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves and the sale of unproved properties. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying amount would be recorded as a permanent impairment.

Stock-based Compensation

The Company uses the fair value method of accounting for options granted to employees and consultants. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model and charged to earnings over the vesting period with a corresponding increase in contributed surplus. Upon the exercise of the stock options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

Multilateral instrument 52-109

Effective march 2006, all reporting issuers in Canada are subject to new disclosure requirements as per Multilateral Instrument 52-109 ("MI 52-109"). As a result of MI 52-109 the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") have to certify that they have designed internal controls over financial reporting to provide reasonable assurance over the reliability of financial reporting and the preparation of external financial statements in compliance with GAAP. In addition, they are subject to a second certification that they have ensured disclosure of changes in internal control that has had or may have a material effect on the Company's internal control.

Disclosure Controls and Procedures

The Company has disclosure controls and procedures to ensure that information required to be disclosed by Sahara is assembled and communication to management. The Company's CEO and CFO have concluded, based on their evaluation as of the end of the period covered by the annual filings, that disclosure controls and procedures are effective to provide reasonable assurance that material information related to Sahara is made

known to them by others within the organization, except as noted below. Though the CEO and CFO certify that Sahara's disclosure controls and procedures are effective to provide a reasonable level of assurance, they are not able to conclude that the disclosure controls and procedures are capable of preventing all frauds and errors. A control system, no matter how well conceived or administrated, can provide only reasonable, not absolute, assurance that the objective of the control system are met.

Internal Controls over Financial Reporting

The CEO and CFO of Sahara are responsible for designing internal controls over financial or causing them to be designed under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purpose in a accordance with Canadian GAAP. Management has assessed the design of the Company's internal control over financial reporting as of the end of the period by the annual filings and have certified that the controls over financial reporting are effective.

Through the review of the records by the CEO and CFO the Company has identified that the recording of joint venture receivable, payable and expenditure transactions volume has increased significantly requiring the addition of accounting staff. The Company is actively recruiting qualified personnel.

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk, which even with a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by Sahara will result in new discoveries of oil and natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones, tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The long-term commercial success of Sahara depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that Sahara will be able to continue to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, Sahara may determine that current markets, terms of acquisition and participations or pricing conditions make such acquisitions or participations uneconomic. Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recover of drilling, completion and operating cost. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful

wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rate over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blowouts, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Sahara Energy Ltd.

Audited Financial Statements

For the years ended December 31, 2006, and 2005

CHARTERED
ACCOUNTANTS

MacKay LLP

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Calgary, Alberta T2P 3H6

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mackay.ca

Auditors' Report

To the Shareholders of Sahara Energy Ltd.

We have audited the balance sheet of Sahara Energy Ltd. as at December 31, 2006 and 2005, and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles

**Calgary, Canada
April 23, 2007**

(Signed) "MacKay LLP"

Chartered Accountants

Sahara Energy Ltd.**Balance Sheets**

December 31,	2006	2005
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Assets**Current**

Cash and cash equivalents	\$ 2,100,405	\$ 2,045,244
Accounts receivable	4,264,325	136,531
Prepaid expenses	74,814	15,316

6,439,544	2,197,091
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Property, plant and equipment (note 3)	13,354,901	1,843,481
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\$ 19,794,445	\$ 4,040,572
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Liabilities**Current**

Accounts payable and accrued liabilities	\$ 6,943,457	\$ 146,992
Convertible debentures (note 5)	785,000	-

7,728,457	146,992
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Asset retirement obligations (note 4)	443,497	-
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Future tax liability (note 8)	1,159,948	135,000
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9,331,902	281,992
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Shareholders' Equity

Share capital (note 6)	11,530,705	3,686,064
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Warrants (note 6)	24,512	193,010
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Contributed surplus (note 7)	870,269	237,814
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Deficit	(1,962,943)	(358,308)
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10,462,543	3,758,580
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\$ 19,794,445	\$ 4,040,572
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Commitments (note 9)**Subsequent events (note 11)****Approved by the Board:**

(Signed) "Peter J. Boswell" _____, Director

(Signed) "Quentin Enns" _____, Director

Sahara Energy Ltd.**Statement of Operations and Deficit**

December 31,	2006	2005
Revenue		
Petroleum and natural gas sales	\$ 818,571	\$ -
Royalties	(125,825)	-
	692,746	-
Expenses		
Production expenses	420,276	-
General and administrative	494,427	128,571
Audit, legal and shareholder reporting	187,091	-
Engineering services	53,277	-
Stock-based compensation	748,406	237,814
Interest expense	89,064	-
Depletion, depreciation and accretion	584,988	2,895
Business promotion	48,806	-
Overhead recoveries	(170,886)	-
	2,411,073	369,280
Loss before other items	(1,718,327)	(369,280)
Other income		
Interest	113,692	10,972
Net loss for the year	(1,604,635)	(358,308)
Deficit, beginning of year	(358,308)	-
Deficit, end of year	\$ (1,962,943)	\$ (358,308)
Loss per common share - basic and diluted	\$ (0.11)	\$ (0.09)
Weighted average number of shares outstanding	14,292,511	3,826,170

Sahara Energy Ltd.**Statement of Cash Flows**

December 31,	2006	2005
Operating activities		
Net loss	\$ (1,604,635)	\$ (358,308)
Items not affecting cash:		
Depletion, depreciation and accretion	584,988	2,895
Stock-based compensation	748,406	237,814
	(271,241)	(117,599)
Changes in non-cash working capital		
Accounts receivable	(4,127,794)	(136,531)
Prepaid expenses	(59,498)	(15,316)
Accounts payable and accrued liabilities	1,275,176	65,368
	(3,183,357)	(204,078)
Financing activities		
Issuance of convertible debentures	1,035,000	-
Issue of common shares	5,911,574	3,895,500
Exercise of stock options and warrants	2,573,498	-
Share issue costs	(149,932)	(266,425)
	9,370,140	3,629,075
Investing activities		
Purchase of resource properties	(11,652,911)	(1,282,650)
Acquisition of property in qualifying transaction	-	(178,726)
Accounts payable for capital expenditures	5,521,289	81,623
	(6,131,622)	(1,379,753)
Increase in cash	55,161	2,045,244
Cash and cash equivalents, beginning of year	2,045,244	-
Cash and cash equivalents, end of year	\$ 2,100,405	\$ 2,045,244
Supplemental cash flow information		
Broker warrants issued for share issue costs	\$ 24,512	\$ 17,694
Shares issued for property acquisition	-	250,000
Asset retirement obligation	418,571	
Convertible debentures converted to shares	250,000	

Year ended December 31, 2006

1. Incorporation and nature of business

Sahara Energy Ltd. ("the Company") was incorporated under the Business Corporations Act (Alberta) and is listed on the TSX Venture Exchange ("the Exchange"). The Company is involved in the production, exploration and development of petroleum and natural gas properties.

2. Significant accounting policies

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles applied on a consistent basis within reasonable limits of materiality and within the framework of the accounting policies summarized below:

a) Revenue recognition

Revenues associated with sales of petroleum and natural gas are recognized when the risks and rewards of ownership are transferred to the buyer. Revenues from royalty interests are recognized when earned and collection is reasonably assured.

b) Measurement uncertainty

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts and presentation of assets, liabilities, revenues, expenses and disclosures of contingencies and commitments. Specifically, the ceiling test and the amounts recorded for depletion, depreciation, and asset retirement obligations are based on estimates of proved reserves, future oil and natural gas prices, future costs and other relevant assumptions. Such estimates primarily relate to unsettled transactions and events at the balance sheet date which are based on information available to management at each financial statement date.

By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements for current and future periods could be significant.

c) Property, plant and equipment

The Company follows the full-cost method of accounting for petroleum and natural gas properties, whereby all costs associated with the exploration for, and development of oil and natural gas reserves, whether productive or unproductive, are capitalized. Costs capitalized include land acquisitions costs, geological and geophysical expenditures, carrying charges on undeveloped properties and drilling and overhead expenses related to exploitation and development of both productive and non-productive wells.

Year ended December 31, 2006

2. Significant accounting policies (continued)

c) Property, plant and equipment (continued)

The Company performs a ceiling test calculation under a two part process. Part I, the recognition of impairment, is determined by comparing the carrying value of property and equipment with the sum of the undiscounted cash flows expected to result from the production of the Company's proved reserves. Cash flows are calculated based on management's best estimate of future prices. If impairment exists, Part II calculates the magnitude of the impairment by comparing the carrying value of the property and equipment to the fair value of proved and probable reserves. Fair value is estimated using accepted present value techniques, which incorporate risk and other uncertainties as well as the future value of reserves when determining expected cash flows. Any excess carrying value above the net present value of future cash flows would be recorded as impairment and charged as additional depletion expense in the statement of operations.

Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, without any gain or loss being recognized, unless such sale would significantly alter the rate of depletion.

Under full cost accounting, petroleum and natural gas properties are depleted using the unit-of-production method based upon estimated proved petroleum and natural gas reserves determined by independent petroleum engineers. Costs of significant unproved properties, net of impairments, are excluded from the depletion calculation. These properties are assessed annually to ascertain whether impairment has occurred.

d) Joint operations

All oil and gas exploration and development activities are conducted jointly with others and accordingly, the Company only reflects its proportionate interest in such activities.

e) Flow-through shares

Resource expenditures deductions for income tax purposes that arise from exploration and development activities and which have been funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. On the date that the Company files the renunciation with the tax authorities, a future income tax liability is recorded and share capital is reduced by the estimated tax benefits transferred to shareholders.

f) Cash and cash equivalents

Cash and cash equivalents consist of amounts on deposit with banks and investments in short-term deposits with original maturities of less than three months.

Year ended December 31, 2006

2. Significant accounting policies (continued)

g) Asset retirement obligation

The Company recognizes the estimated fair value of an asset retirement obligation ("ARO") in the period in which it is incurred when a reasonable estimate of the fair value can be made. The fair value of the estimated ARO is recorded as a liability with a corresponding increase in the carrying amount of the related asset. ARO is initially measured at fair value and subsequently adjusted for the accretion of discount and any changes to the underlying cash flows. The capitalized amount is depleted on a unit-of-production basis over the life of the proved reserves. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost will result in an increase or decrease to ARO. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded.

h) Convertible debentures

Convertible debentures are recorded at the amount of proceeds received less the amount attributed to the conversion feature which is included as part of shareholders' equity. The difference between the recorded amount and the face value of the convertible debentures is charged to income and included in accretion on convertible debentures using an effective yield basis.

The value of the conversion option was assessed at the date of issuance to be nominal and as such no amount was recorded for the value of the conversion feature.

i) Loss per share

Basic per share amounts are computed by dividing the net earnings by the weighted average number of common shares outstanding for the year. Diluted per share amounts reflect potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares. Diluted per share information is calculated using the treasury stock method that assumes any proceeds received by the Company upon the exercise of in-the-money stock options, plus unamortized stock-based compensation cost, would be used to buy back common shares at the average market price for the period. Anti-dilutive options or instruments are not included in the calculation and all options and instruments are considered anti-dilutive when the Company is in a loss position.

j) Stock-based compensation

The Company uses the fair value method of accounting for options granted to employees and consultants. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model and charged to earnings over the vesting period with a corresponding increase in contributed surplus. Upon the exercise of the stock options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest; rather the Company accounts for actual forfeitures as they occur.

Notes to the Financial Statements

Year ended December 31, 2006

2. Significant accounting policies (continued)

k) Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, current income taxes are recognized for the estimated income taxes payable for the current period. Future income tax assets and liabilities are recognized in the current period for temporary differences between the tax and accounting bases of assets and liabilities as well as for the benefit of losses available to be carried forward to future years for tax purposes. Future income tax assets and liabilities are measured using substantively enacted tax rates and laws expected to apply in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on future income tax assets and liabilities is recognized in operations in the period that includes the substantive enactment date. Future income tax assets are limited to the amount that is more likely than not to be realized

l) Other property, plant and equipment

The Company amortizes other property, plant and equipment on the declining balance method at the following rates unless otherwise noted:

Office furniture and equipment	20%
Computer equipment	30%
Leasehold improvements	SL – Over life of the lease

The rates are reduced by one-half in the year of acquisition.

3. Property, plant and equipment

			2006
	Cost	Accumulated amortization	Net book value
Petroleum and natural gas properties	\$ 13,827,816	\$ 542,542	\$ 13,285,274
Furniture, equipment and leasehold improvements	90,042	20,415	69,627
	\$ 13,917,858	\$ 562,957	\$ 13,354,901
			2005
	Cost	Accumulated amortization	Net book value
Petroleum and natural gas properties	\$ 1,819,761	\$ -	\$ 1,819,761
Furniture and equipment	26,615	2,895	23,720
	\$ 1,846,376	\$ 2,895	\$ 1,843,481

Notes to the Financial Statements

Year ended December 31, 2006

3. Property and equipment (continued)

Costs excluded from depletion for 2006 - \$3,729,621 (2005 - \$1,819,761) as these costs are for unproved and major development projects at year end. The Company conducted a separate impairment test on these properties and concluded that no impairment had occurred.

Capitalized costs directly related to the properties is \$210,237 (2005 - \$nil).

The Company's ceiling test calculation, performed at December 31, 2006, resulted in no additional depletion recorded. The future prices used by the Company in estimating cash flows were based on forecasts by an independent reserves evaluator, adjusted for the Company's quality and transportation differentials. The following table summarizes the benchmark prices used in the calculation at an exchange rate of \$1 CDND to \$0.862 USD:

	WTI UNESC \$/US/BBL	WT1 @Cushing \$/US/BBL	EDM Oil price D2S2 \$/BBL	Heavy Oil 25 API Hardisty \$/BBL	Heavy Oil 12 API Hardisty \$/BBL	NYMEX Henry Hub Reference US\$/Mcf
2007	65.00	65.00	75.12	53.34	44.25	7.35
2008	63.00	65.52	75.71	54.51	45.01	7.86
2009	60.00	64.27	74.26	54.21	45.21	7.70
2010	56.50	61.73	71.30	52.76	44.26	7.50
2011	53.00	59.07	68.20	51.15	43.15	7.70
2012	52.00	59.11	68.25	51.19	43.19	7.80
2013	52.00	60.29	69.62	52.21	44.21	7.96
2014	52.00	61.50	71.01	53.26	45.26	8.12
2015	52.00	62.73	72.43	54.32	46.32	8.28
2016	52.00	63.98	73.88	55.41	47.41	8.44
2017	52.00	65.26	75.35	56.52	48.52	8.65
2018	52.00	66.57	76.88	57.65	49.65	8.87
Thereafter	+ 2%/year	+ 2%/year	+2%/year	+2%/year	+2%/year	+ 2%/year

4. Asset retirement obligations

At the date of completion of drilling and testing, the Company identified obligations related to oil and gas properties and records a liability equal to the present value of expected future assets retirement obligations. The total future ARO was estimated by management based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company has estimated the net present value of its total ARO to be \$443,497 as at December 31, 2006 based on an undiscounted future liability of \$816,178 and incorporated the Company's credit-adjusted risk-free interest rate of 9.0% and inflation rate of 2%. These payments are expected to be made over the next eight years.

Year ended December 31, 2006

4. Asset retirement obligations (continued)

The following table reconciles the Company's asset retirement obligations:

	2006
Balance, beginning of year	\$ -
New liabilities incurred	418,571
Accretion expense	24,926
Balance, end of year	\$ 443,497

5. Convertible debentures

The Company issued 1,035, 10% convertible debentures at a price of \$1,000 per debenture for aggregate gross proceeds of \$1,035,000. The debentures are convertible into one unit at price of \$0.57 per unit at the option of holder. Each unit is comprised of one common share and one common share purchase warrant. Each warrant is exercisable into one common share at a price of \$0.57 until December 31, 2007. The debentures are convertible in whole or in part, at any time prior to maturity at the option of the holder. The holder may also convert the debentures into cash at anytime after December 31, 2006 on the basis of repayment of the principal amount together with accrued and unpaid interest to the date of conversion.

The Company at its sole discretion may redeem the outstanding debentures together with accrued interest thereon on or after December 31, 2006 provided that, prior to redemption, the Company shall have provided written notice to the holders and which notice provides thirty days for the holders to convert their debenture into units of common shares and warrants pursuant to the convertibility provision of the debentures. If the holder does not exercise his right of conversion, the debentures are redeemable by the Company and shall be purchased at a redemption price of 105% of the principal amount of the debentures plus accrued and unpaid interest to the date of redemption.

The debentures are also automatically convertible at the option of the holder in the event that the Company fails to pay interest or failure to repay the principal amount and accrued interest on the maturity date.

The Company assessed the fair value of the repayment obligation and concluded that it was equivalent to the face value of the debentures issued. Accordingly, no value was assigned to the conversion option.

During the year, debentures with a face value of \$250,000 in debentures were converted into units of the Company at a price of \$0.57 per unit resulting in 438,589 units being issued. Each unit consists of one common share and one common share purchase warrant. On conversion the Company issued in aggregate 438,589 common shares and 438,589 common share purchase warrants.

Notes to the Financial Statements

Year ended December 31, 2006

5. Convertible debentures (continued)

	2006
Balance, beginning of year	\$ -
Issuances	1,035,000
Conversions	(250,000)
Balance, end of year	\$ 785,000

6. Share capital

Authorized:

Unlimited number of:
Common voting shares
Preferred non-voting shares

Issued:

	2006		2005	
	Shares	Amount	Shares	Amount
Common shares				
Balance beginning of year	10,716,000	\$ 3,686,064	-	\$ -
On incorporation	-	-	1,900,000	237,500
Initial public offering	-	-	2,000,000	500,000
Business acquisition	-	-	500,000	250,000
Conversion of debentures	438,589	250,000		
Private placement of flow-through shares	4,345,892	5,911,574	6,116,000	3,058,000
Value assigned to warrants			-	(181,243)
Exercise of options	387,500	240,951	100,000	25,000
Exercise of warrants	3,480,102	2,641,508	100,000	80,927
Share issue costs		(174,444)	-	(284,120)
Tax effect of flow-through share Renunciation	-	(1,024,948)	-	-
Balance end of year	19,368,083	\$ 11,530,705	10,716,000	\$ 3,686,064

Notes to the Financial Statements

Year ended December 31, 2006

6. Share capital (continued)

	Number of warrants	Amount	Number of warrants	Amount
Warrants				
Balance, beginning of year	3,158,000	\$ 193,010	-	\$ -
Issuance of warrants	38,540	24,512	3,258,000	198,937
Issuance of warrants on conversion of debentures (note 5)	438,589	-	-	-
Exercise of warrants	(3,480,102)	(191,788)	(100,000)	(5,927)
Expired	(20,000)	(1,222)	-	-
Balance, end of year	135,027	\$ 24,512	3,158,000	\$ 193,010

The Company has assigned values to warrants issued as compensation to brokers as part of the year end private placements. The warrants were issued for a one year term with an exercise price of \$1.50 per warrant. The values assigned to the warrants were determined by using the Black-Scholes option pricing model with a volatility rate of 119% and a risk free interest rate of 5.0%.

Options

As at December 31, 2006, the following options were outstanding:

Options outstanding	Option price	Weighted average remaining contractual life	Number of options currently exercisable	Weighted average exercisable price of options currently exercisable
1,460,000	0.40	3.92	1,095,000	0.40
300,000	1.00	4.08	150,000	1.00
80,000	1.25	4.17	40,000	1.25
260,000	1.00	4.42	86,667	1.00
190,000	1.00	4.75	47,500	1.00
2,290,000	0.63	3.69	1,419,167	0.63

Under the Company's stock option plan, the Company may grant options to employees, officers and directors up to 10% of its issued and outstanding common shares. In addition, the aggregate number of shares so reserved for issuance to any one person shall not exceed 5% of the issued and outstanding shares. Under the plan, options are exercisable at varying vesting provisions for a maximum term of five years.

Notes to the Financial Statements

Year ended December 31, 2006

6. Share capital (continued)

	Stock options	Weighted average exercise price (\$)	Stock options	Weighted average exercise price (\$)
Outstanding, beginning of year	2,200,000	0.38	-	-
Granted	830,000	1.05	2,300,000	0.37
Exercised	(387,500)	0.32	(100,000)	0.25
Cancelled	(352,500)	0.36	-	-
Outstanding, end of year	2,290,000	0.63	2,200,000	0.38

To December 31, 2006, the Company recorded compensation expense of \$618,405 included in contributed surplus as determined based on the fair value of the stock options at the grant date estimated using the Black-Scholes model with the following assumptions:

	2006	2005
Volatility rate	80-118%	69-88%
Risk-free interest rate	5.0%	5.0%
Dividend yield rate	0.00%	0.00%
Forfeiture rate of	0.00%	0.00%
Weighted average life	5.00 years	5.00 years

Escrow

As at December 31, 2006, there were 1,440,000 shares held in escrow.

7. Contributed surplus

A summary of the status of contributed surplus as of December 31, 2006 and the changes during the year is presented below:

	2006	2005
Balance, beginning of year	\$ 237,814	\$ -
Fair value assigned to stock options	748,406	237,814
Fair value of options exercised	(115,951)	-
Balance, end of year	\$ 870,269	\$ 237,814

Notes to the Financial Statements

Year ended December 31, 2006

8. Income taxes

(a) Income tax expense

The provision for income tax reflects an effective income tax rate which differs from federal and provincial statutory income tax rates. The main difference is as follows:

For the years ended December 31,	2006	2005
Loss before income taxes	\$ (1,604,635)	\$ (358,308)
Enacted income tax rate	35.77%	37.62%
Expected income tax recovery	\$ (574,000)	\$ (135,000)
Increase (decrease) in taxes resulting from:		
Resource allowance	25,000	-
Stock-based compensation	268,000	90,000
Non-deductible expenses	25,000	-
Impact of change in effective tax rate	30,000	-
Valuation allowance	226,000	45,000
Income tax expense	\$ -	\$ -

(b) Components of the net future income tax asset (liability)

Temporary differences and carry forwards that give rise to future income tax assets as of December 31, 2006 and 2005 are as follows:

As at December 31,	2006	2005
Non-capital losses	\$ 300,000	\$ 61,000
Property, plant and equipment	(1,190,948)	(135,000)
Share issue costs	94,000	72,000
Total gross future tax asset (liability)	(796,948)	(2,000)
Valuation allowance	(363,000)	(133,000)
Net future income tax liability	\$ (1,159,948)	\$ (135,000)

The valuation allowance offsets the net future income tax assets for which there is no assurance of recovery. The valuation allowance is evaluated considering positive and negative evidence about whether the future income tax assets will be realized. At the time of evaluation, the allowance is either increased or reduced, reduction could result in the complete elimination of the allowance, if positive evidence indicated that the value of the future income tax assets is no longer impaired and the allowance is no longer required.

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